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THE CHANGING PATTERN OF JAPANESE TRADE: NORTHEAST ASIA

Summary

Several of the world's most economically dynamic countries are located in Northeast Asia: South Korea, Taiwan, the People's Republic of China, the Soviet Union and, of course, Japan. For nearly three decades, one or more countries in the region have experienced explosive growth -- Japan during the 1950-70 period and since that time South Korea, Taiwan and China. In the 1980s, however, the region entered a new era of economic and trade patterns. Although Japan, South Korea, China and Taiwan continue to focus on exporting to the United States as in previous years, trade within the region is taking on greater importance and complexity. This is particularly true for Japan as a result of forces unleashed by the strong yen, market deregulation and economic restructuring.

Background

Economic reconstruction was the central postwar task for all the countries of the region. Unfortunately for Taiwan and China, the communist revolution and its aftermath diverted them from this issue well into the 1950s, while civil war delayed Korea's rebuilding efforts for several years. Japan immediately set out on the road to recovery under the aegis of the American occupation and even benefited from the Korean conflict by serving as a convenient source of supply for the United Nations forces. By the start of the 1960s, Japan was well on its way to achieving the ambitious "income doubling" goal its leaders had set. In contrast, Japan's neighbors were only beginning to address seriously the issues of economic development. The Soviet Union was clearly an

exception to this point, but its attention was directed mainly toward Europe. The Asian republics were far down on Moscow's list of economic priorities.

The countries exhibit certain common traits that have bolstered their economic performance: a strong work ethic, a sense of social order, and an emphasis on the importance of education. A history of free-market mechanisms is also common to the solely Asian nations, although this was a major obstacle to "proper" development from Beijing's point of view. In terms of natural resources, there is a clear division between China and the Soviet Union and the other nations. Trade, therefore, carries a different weight in Seoul, Taipei and Tokyo than it does in Beijing or Moscow. For the former group importing raw materials and exporting finished products is the only realistic approach. This is not true for the latter.

In terms of population and land mass, there is also a clear hierarchy with South Korea and Taiwan at the low end, Japan in the middle, and China and the Soviet Union at the top. The economic impacts of size are varied and subtle. While a small population and area are easier to administer, they also preclude the benefits of economies of scale without resorting to trade. On the other hand, too large a population and land mass, while offering the possiblity of autarkic growth, poses problems of command and control (especially to centralized, non-market economies). Japan was fortunate that it had a large enough market for domestic firms to grow and compete behind trade barriers, but not so large as to present serious administrative problems.

In addition to these physical factors, geopolitical considerations also bear significantly on economic priorities. Every nation except Japan has felt it necessary to channel a significant part of its resources into military channels. Restrained by its constitution and protected by the American nuclear umbrella, Japan has made only minimal forays into this economically sterile field.

A panoply of trade and financial controls was designed by these nations in response to the problems of postwar development. Behind a wall of barriers, import-substituting industrialization was pursued with varying degrees of success. By combining foreign technology with low cost labor, Japan, Taiwan, South Korea and China scored impressive gains in productivity. Despite these barriers, Japanese trade within the region prospered. Thanks to its headstart on reconstruction, Japan supplied most of the manufactured inputs required by Taiwan and South Korea to rebuild their economies in exchange for raw materials or light manufactures. There has been a natural progression up the value-added scale in the composition of trade -- a progression accelerated by recent economic developments.

Overview of Trade

Total Japanese exports in 1986 were 24.7 times their 1965 level, while imports were 15.5 times higher. Exports to Korea ballooned to 58.1 times 1965's figure and imports swelled 128.1 times. For Taiwan, exports expanded 36 times and imports 29.8. Trade with the Soviet Union did not keep pace with

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overall trade growth: 1986 exports were only 18.7 times higher than in 1965 and imports just 8.2 times more. Trade with China was also mixed; exports in 1986 were 40.2 times the 1965 level, but imports were only 10.7 times as great (see Figure 1 and Table).

As for the importance of bilateral trade in terms of overall trade, there is a wide divergence between Japan and its neighbors. Tokyo's 1986 trade with Korea (5 percent for exports and 4.2 percent for imports), Taiwan (exports 3.8 percent and imports 3.7 percent), China (4.7 percent for exports and 4.5 percent for imports) and the Soviet Union (1.5 percent and 1.6 percent, respectively) ranked well below its value with the United States or Europe. Trade with Northeast Asian nations, however, was on a par with Southeast or South Asian trade.

Despite these undistinguished numbers, Northeast Asian trade receives a disproportionate amount of attention from Tokyo for a variety of reasons. Trade with Korea is influenced by security considerations, and with the peninsula a flashpoint, fostering South Korea's stability and strength is an important aim of foreign policy. Relations with Moscow are also heavily influenced by security concerns. China represents a vast potential market and competitor, making sound political and trade relations essential for future growth. Since breaking relations with Taipei in 1972, Tokyo has dealt with Taiwanese issues in a circumspect manner. Increasing Japanese investment there may change this, however.

From the viewpoint of the country's trading partners (except for the Soviet Union), trade with Japan is much more important. Japan bought 14.9 percent of South Korea's 1986 exports and sold it 31.4 percent of its imports. The comparable figures for Taiwan are 11 percent and 25 percent, respectively; for China, 18 percent and 22.7 percent. Although these shares represent a sharp drop from 1965 levels in the cases of South Korea (23.6 percent of exports and 55 percent of imports) and Taiwan (35 percent and 39.2 percent, respectively), the disparity in dependence remains significant. Only Soviet trade with Japan has remained steady at about 5 percent for exports and 7 percent for imports.

Composition of Trade

More interesting than just the growth of Japan's trade in Northeast Asia is its changing composition. The gradual shift in the export/import mixture with each country reveals the impact of economic evolution.

South Korea - In 1975 Japanese exports to South Korea were dominated by machinery and transportation equipment (39.9 percent), followed by chemicals (19.5 percent), metals and metal manufactures (15.5 percent), miscellaneous manufactures (12.9 percent) and textiles (10.8 percent). In 1986 machinery and transportation equipment (which includes computers, machine tools, electronics equipment and automotive components) had increased to 57.8 percent, while textiles fell by half to 5 percent, chemicals declined to 13.2 percent and metals and metal manufactures dropped to 13.5 percent (see Figure 2). A closer inspection of the machinery group reveals interesting developments. Office equipment (0.5 percent in 1975; 4.1 percent in 1986), metalworking machinery (rising from 2.4 percent to 3.9 percent), electric machinery (from 1.5 percent

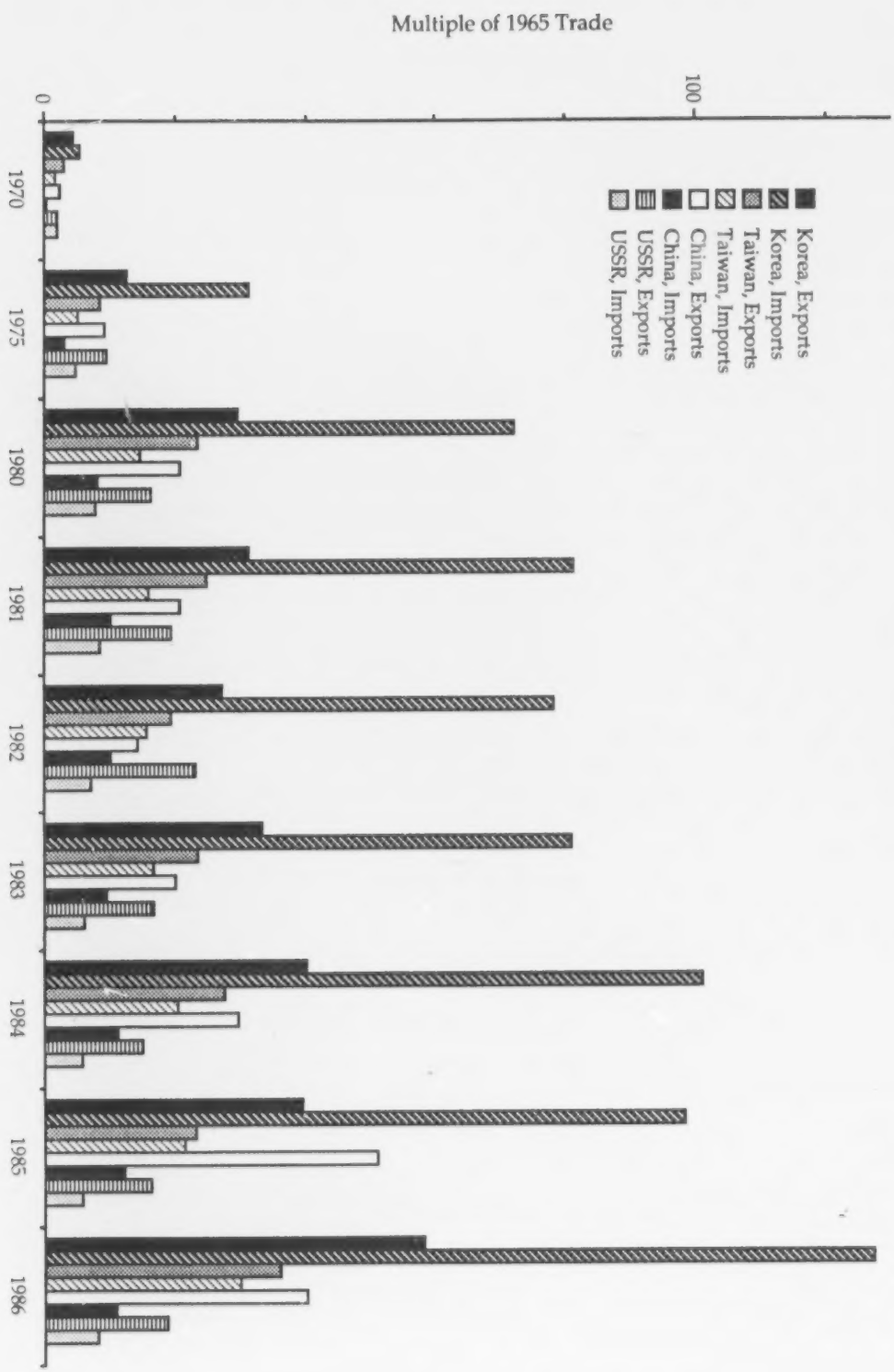


Figure 1: **Japan's Trade with Northeast Asia**

(1965 = 1.00)

Japan's Trade with Northeast Asia, 1965-1986

(in thousands of dollars)

Year	Global Total			South Korea			Taiwan		
	Exports	Imports	Balance	Exports	Imports	Balance	Exports	Imports	Balance
1965	$8,451,742	$8,169,019	$282,723	$180,304	$41,315	$138,989	$217,916	$157,317	$60,599
1966	9,776,391	9,522,702	253,689	335,170	71,688	263,482	255,378	147,396	107,982
1967	10,441,572	11,663,087	-1,221,515	406,959	92,382	314,577	328,154	167,088	161,066
1968	12,971,662	12,987,243	-15,581	612,653	101,630	511,023	471,626	150,721	320,905
1969	15,990,014	15,023,536	966,478	767,191	133,927	633,264	606,358	180,516	425,842
1970	19,317,687	18,881,168	436,519	818,175	228,970	589,205	700,418	250,765	449,653
1971	24,018,881	19,711,749	4,307,132	855,687	274,421	581,266	923,332	286,017	637,315
1972	28,591,144	23,470,710	5,120,434	979,793	425,992	553,801	1,090,616	421,864	668,752
1973	36,929,971	38,313,604	-1,383,633	1,789,115	1,207,309	581,806	1,641,759	890,696	751,063
1974	55,535,755	62,110,456	-6,574,701	2,656,056	1,568,041	1,088,015	2,009,007	955,188	1,053,819
1975	55,752,805	57,863,088	-2,110,283	2,247,723	1,307,999	939,724	1,821,669	811,587	1,010,082
1976	67,225,483	64,798,968	2,426,515	2,824,464	1,916,773	907,691	2,279,765	1,189,830	1,089,935
1977	80,494,793	70,808,654	9,686,139	4,079,602	2,113,399	1,966,203	2,552,676	1,288,666	1,264,010
1978	97,543,143	79,343,043	18,200,100	6,003,046	2,591,029	3,412,017	3,584,744	1,750,153	1,834,591
1979	103,031,640	110,672,248	-7,640,608	6,246,890	3,359,416	2,887,474	4,366,850	2,475,920	1,890,930
1980	129,807,025	140,527,652	-10,720,627	5,368,310	2,996,272	2,372,038	5,145,799	2,293,366	2,852,433
1981	152,030,247	143,289,675	8,740,572	5,657,863	3,388,915	2,268,948	5,404,570	2,522,501	2,882,069
1982	138,831,166	131,931,214	6,899,952	4,881,133	3,253,813	1,627,320	4,255,369	2,443,115	1,812,254
1983	146,927,471	126,393,051	20,534,420	6,003,770	3,364,954	2,638,816	5,085,999	2,622,317	2,463,682
1984	170,113,888	136,503,049	33,610,839	7,226,822	4,212,740	3,014,082	5,986,193	3,203,935	2,782,258
1985	175,637,772	129,538,747	46,099,025	7,097,214	4,091,949	3,005,265	5,025,462	3,385,531	1,639,931
1986	209,151,151	126,407,786	82,743,365	10,474,500	5,291,970	5,182,530	7,851,703	4,690,521	3,161,182

Year	China			U.S.S.R.		
	Exports	Imports	Balance	Exports	Imports	Balance
1965	$245,036	$527,076	$-282,040	$168,358	$240,198	$-71,840
1966	315,150	306,237	8,913	214,022	300,361	-86,339
1967	288,294	269,439	18,855	157,688	453,688	-296,000
1968	325,439	224,185	101,254	179,018	463,512	-284,494
1969	390,803	234,540	156,263	268,247	461,563	-193,316
1970	568,878	253,818	315,060	340,932	481,038	-140,106
1971	578,188	323,172	255,016	377,267	495,880	-118,613
1972	608,921	491,116	117,805	504,179	593,906	-89,727
1973	1,039,494	974,010	65,484	484,210	1,077,701	-593,491
1974	1,984,475	1,304,768	679,707	1,095,642	1,418,143	-322,501
1975	2,258,577	1,531,076	727,501	1,626,200	1,169,618	456,582
1976	1,662,568	1,370,915	291,653	2,251,894	1,167,441	1,084,453
1977	1,938,643	1,547,344	391,299	1,933,877	1,421,875	512,002
1978	3,048,748	2,030,292	1,018,456	2,502,195	1,441,723	1,060,472
1979	3,698,670	2,954,781	743,889	1,461,464	1,910,681	-449,217
1980	5,078,335	4,323,374	754,961	2,778,233	1,859,866	918,367
1981	5,095,452	5,291,809	-196,357	3,259,415	2,020,706	1,238,709
1982	3,510,936	5,352,417	-1,841,481	3,898,841	1,682,017	2,216,824
1983	4,912,334	5,087,357	-175,023	2,821,249	1,456,001	1,365,248
1984	7,216,712	5,957,607	1,259,105	2,518,314	1,393,987	1,124,327
1985	12,477,446	6,482,686	5,994,760	2,750,583	1,429,255	1,321,328
1986	9,856,178	5,652,351	4,203,827	3,149,547	1,972,033	1,177,514

Figure 2: Japan's Exports to South Korea

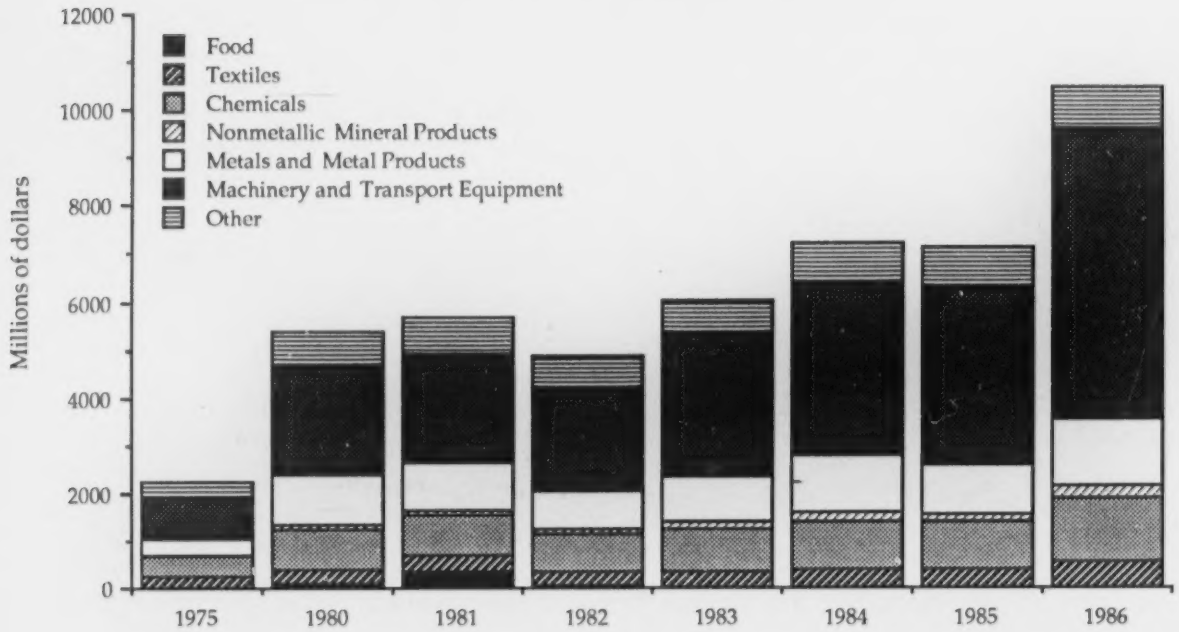
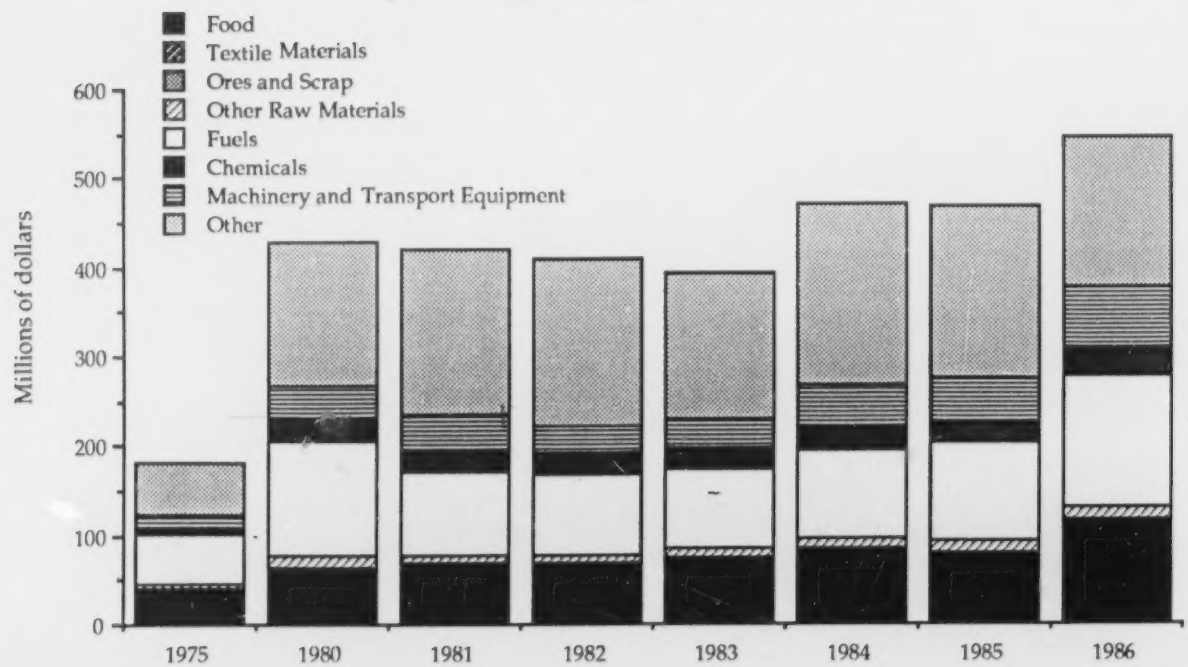


Figure 3: Japan's Imports from South Korea



to 2.9 percent), precision equipment (1 percent to 2 percent) and television tubes (2.4 percent to 7.3 percent) increased their relative shares. Products registering declines included: cars and trucks (0.6 percent to 0.1 percent), ships (3.6 percent to 0.3 percent), textile machinery (2.4 percent to 1.6 percent) and sewing machines (0.5 percent to 0.2 percent). In sum, Japan has moved toward providing higher value-added products as the South Korean economy has developed.

On the import side, the picture is equally interesting (see Figure 3). Japanese purchases of food have remained relatively stable (ranging from 20 percent to 25 percent of imports), as have machinery and transportation equipment imports (in the 10-12 percent range). Chemicals (2.4 percent to 6.1 percent) and petroleum products (3.2 to 5.6 percent) have gained as groups. Individually, imports of steel (1 percent to 10 percent), office equipment (0.2 percent to 0.7 percent) and precision equipment (1.6 percent to 2.8 percent) have shown significant gains. Just as Japanese exports to Korea reflect higher value added, so do Korean exports to Japan reveal an advancing degree of industrial capability.

Taiwan - Much the same can be said for Japan-Taiwan trade -- Japan has gradually abandoned low-end products for higher value added as the Taiwanese economy has expanded. Deliveries of textiles, chemicals (particularly fertilizers), plastics, metals and metal manufactures, radios, watches and transportation equipment plummeted between 1975 and 1986. Shipments of office equipment, electric machinery and television tubes, on the other hand, have grown.

Chemicals, metals and metal manufactures and office equipment have garnered a larger share of Taiwan's shipments to Japan, while food, scrap metal and other raw materials have all lost ground. In general the thrust of Taiwan's exports appears more narrow than South Korea's efforts. The former appears to be focusing on industrial supplies, while South Korea is also moving into consumer markets (see Figures 4 and 5).

China - Trade with China has been erratic under the influence of changing political winds in Beijing. The current reformist regime of Deng Xiaoping has enabled trade not just to bloom but explode (see Figres 6 and 7). China's decision to liberalize agriculture and focus on light industry and consumer demand dovetail with Japan's export and import needs. Shares of finished consumer goods and industrial machinery in Japan's exports to China showed phenomenal growth between 1975 and 1986: cars and trucks were up from 3.6 percent to 6.2 percent (although they captured 12 percent in 1985); radios rose to 0.4 percent from 0.02 percent; televisions from 0.1 percent to 1.5 percent (8 percent in 1985); textile machinery from 0.7 percent to 2.7 percent; metalworking equipment from 1.9 percent to 3 percent; and office machinery from 0.17 percent to 1.2 percent. Not surprisingly, Japan's exports of light manufactures have dropped, including all categories of textiles, metals and metal manufactures.

Japan's imports from China continue to be dominated by mineral fuels, although their share dropped from 49 percent in 1975 to 29.4 percent in 1986. Imports of intermediate goods (petroleum products, industrial chemicals, steel, nonferrous metals and textiles) and light manufactures like toys have surged. The same process reflecting industrial development is clear, but at an earlier stage than in the cases of trade with South Korea or Taiwan.

Figure 4: Japan's Exports to Taiwan

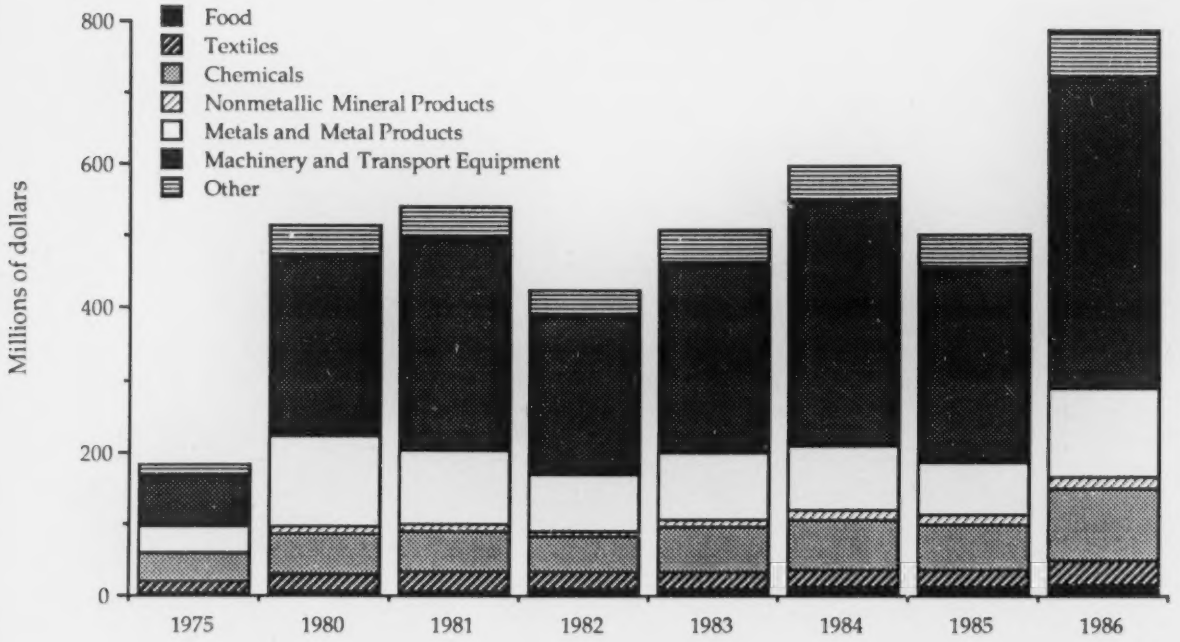


Figure 5: Japan's Imports from Taiwan

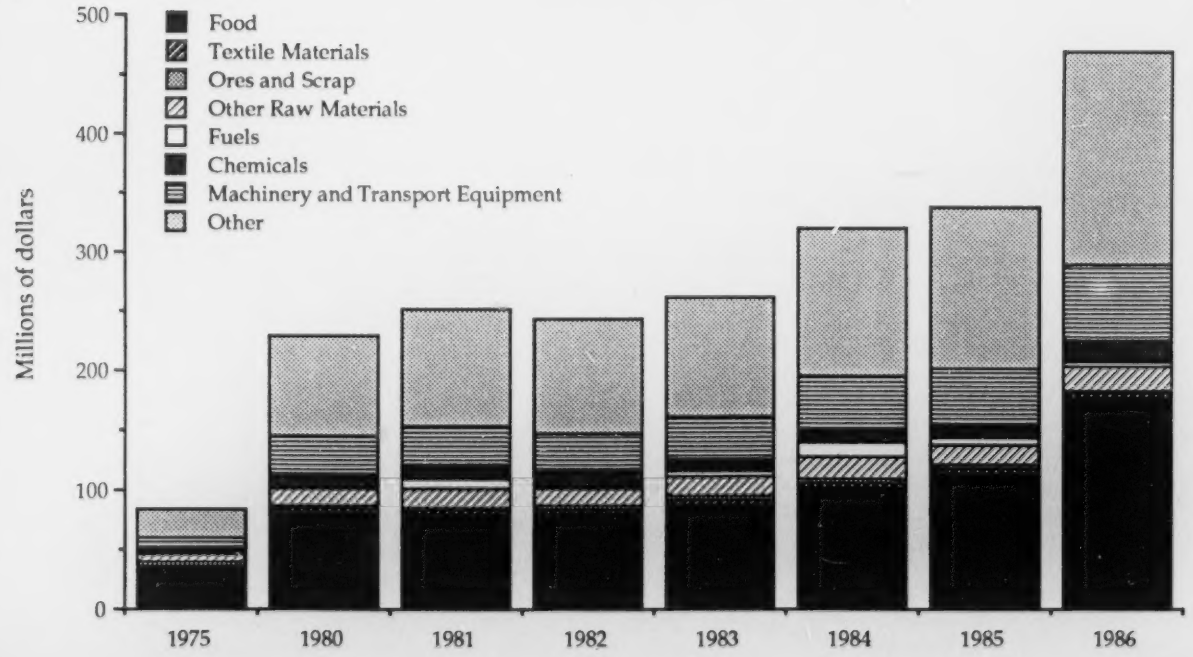


Figure 6: **Japan's Exports to China**

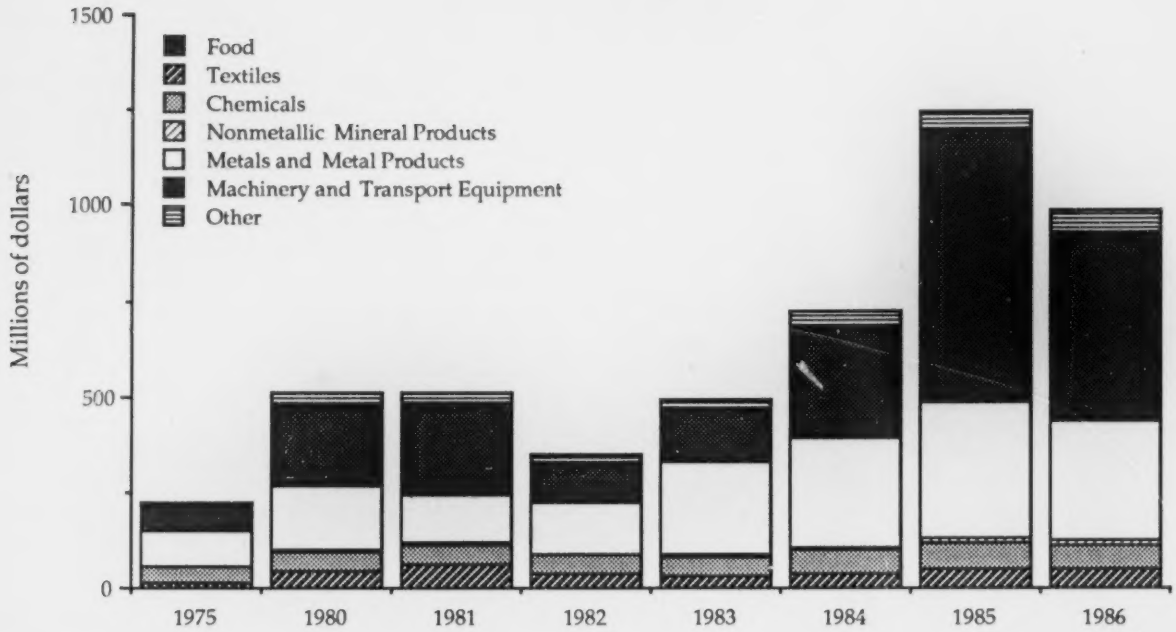
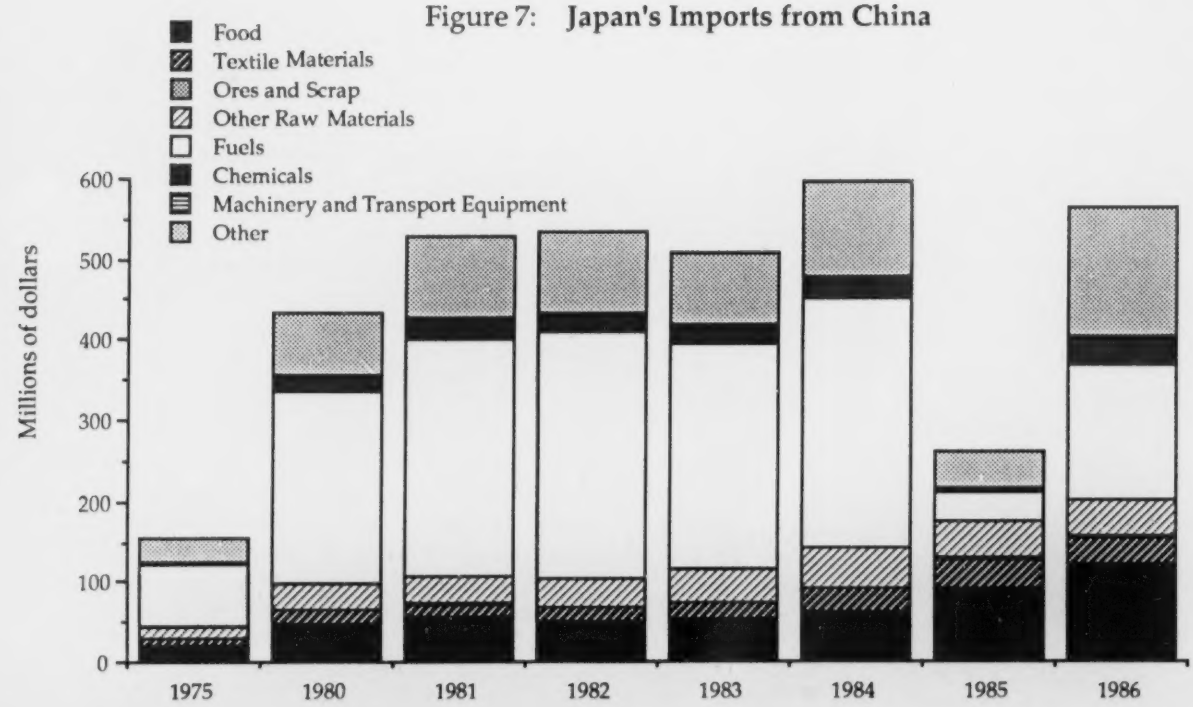


Figure 7: **Japan's Imports from China**



Soviet Union - In contrast Japan's export trade with the Soviet Union appears relatively static, although imports show a sharp shift (Figures 8 and 9). Political considerations have severely limited trade opportunities, holding down overall growth. Nevertheless, there is a slight shift in Japanese exports away from commodity items toward specialized goods: shipments of textiles, plastics and metal manufactures have drifted lower while pharmaceuticals and electric and precision machinery have gained.

This trend away from basic products also distinguishes Soviet exports to Japan -- not unexpectedly since the Soviet Union is an advanced industrialized nation. Japanese purchases of textile materials, scrap metal and other industrial inputs have declined sharply since 1975, as deliveries of final goods grabbed the lion's share of trade, rising from 15.9 percent in 1975 to 40.4 percent in 1986.

Rapid economic growth has had a steady impact on trade patterns, with the export/import mix showing an increase in value added as industrialization has progressed. Although this trend would continue under any circumstances, the yen's sharp appreciation combined with Tokyo's economic restructuring efforts will accelerate it.

The Impact of the Strong Yen

The yen's 60 percent-plus appreciation against the dollar since late September 1985 has forced Japanese businessmen to adopt strategies that have become more attractive as a result of the deregulation of financial and goods markets.

- Purchases from abroad - The strong yen has made foreign manufactures cheaper, particularly those from countries that peg their currency to the dollar (China, Taiwan and South Korea). Even though Taipei and Seoul have allowed their currencies to appreciate against the dollar (4.8 percent for the won and 23 percent for the new Taiwan dollar), product prices remain well below those in Japan. As the yen has climbed steadily, Japanese efforts to increase offshore procurement have become almost frantic. As a result imports from Korea for the first five months of 1987 jumped 54.2 percent over the same period in 1986, while the figure for Taiwan is an equally impressive 54.8 percent. Imports from China (up 10.8 percent) and the Soviet Union (down 4.2 percent) were not affected.

The effect has also reached retailers, with large department stores devoting shelf space to Korean consumer electronics and other durables as well as nondurable goods. The attraction is price -- up to 25 percent below domestic goods. So far retailers have reported customer complaint rates for Korean products are no higher than for Japanese makes. Retailers are urging Korean makers to establish service networks in Japan in order to bolster the appeal of their products.

The strong yen has had a balancing impact, however. American buyers also face the same relative price increase for Japanese goods and have responded by purchasing more from South Korea and Taiwan. The catch is that key components of Korean-made consumer electronics and automotive products are purchased from Japan. The more the Koreans sell, the more they have to buy from

Figure 8: **Japan's Exports to the U.S.S.R.**

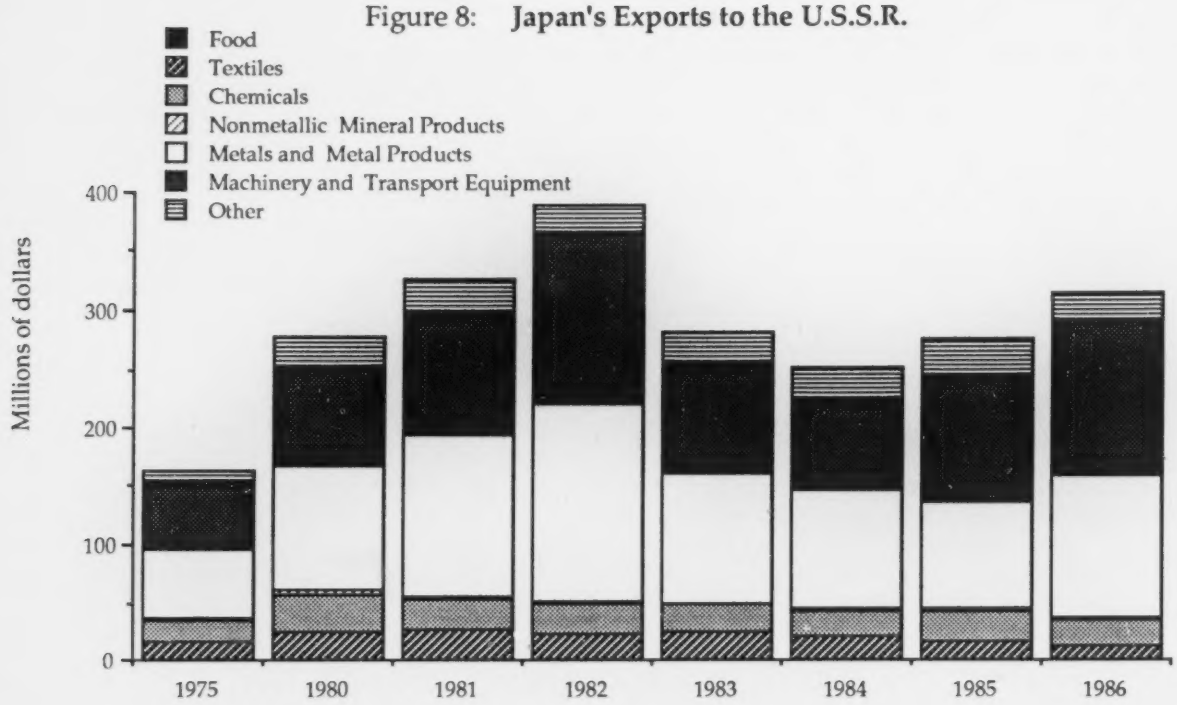
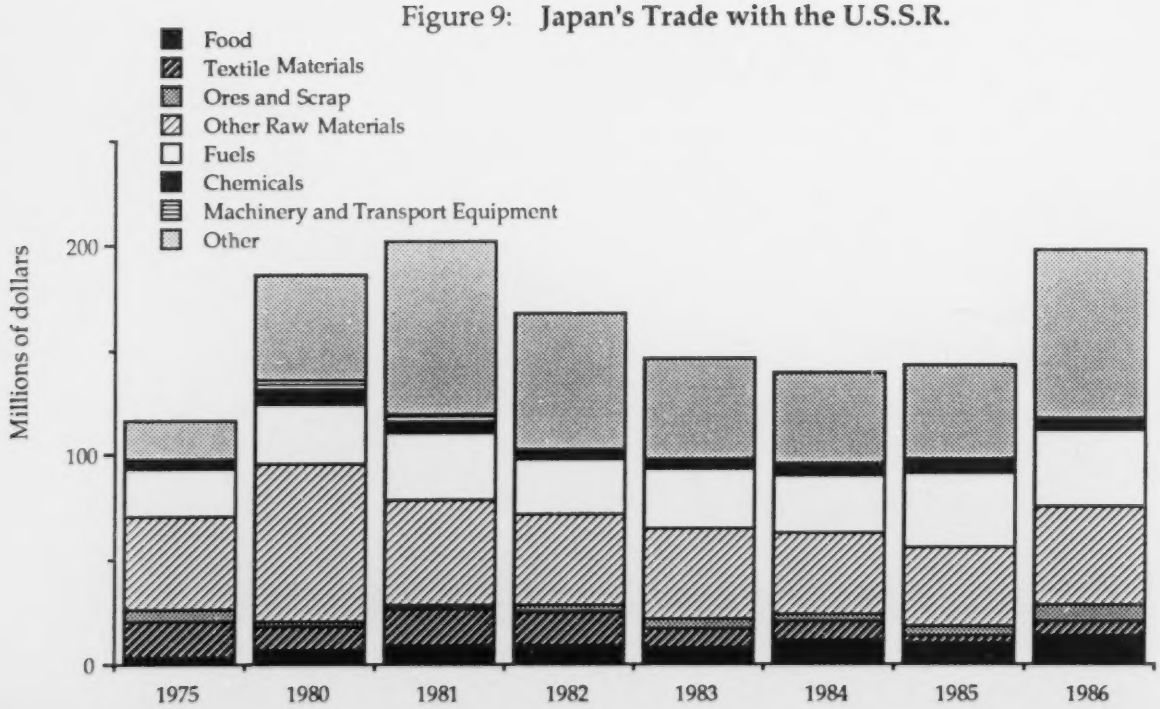


Figure 9: **Japan's Trade with the U.S.S.R.**



Japan. According to a Japanese bank, Korea's dependence on Japanese components ranges as high as 99.2 percent for light bulbs, 96.5 percent for sound recording units, 79.9 percent for automotive components, 53.9 percent for integrated circuits and 34.9 percent for electronic measuring instruments (see JEI Report No. 24B, June 26, 1987).

Total Japanese exports to Korea were up 33.5 percent for the first five months of this year, with shipments of television tubes and other electronic components up 74 percent. Exports to Taiwan were equally active, rising 99.5 percent on the strength of a 71 percent jump in metals and metal manufactures and a 68 percent increase in machinery. These figures certainly reflect the appreciation of the yen, but the fact remains that Korean and Taiwanese exports exert a strong pull on Japanese exports. Furthermore, it will take some time for the Koreans and Taiwanese to diversify their sources, if it is possible at all (few alternatives exist for videocassette recorder heads, for example).

• Foreign direct investment - After criticizing American firms for moving factories abroad when the dollar rose to unprecedented heights in the early 1980s, Japan is in exactly the same situation and is acting in exactly the same way. Major and mid-level firms are moving production of simple assemblies, parts and products to Taiwan, South Korea, China, Mexico and other low-wage nations with obvious implications for a shift in trade patterns over the long term.

According to the latest figures on foreign direct investment, Japanese businessmen doubled the amount of money going to Taiwan and tripled the flow to Korea in fiscal 1986 (see JEI Report No. 25B, July 2, 1987). Press reports say a wide range of firms is investing in production facilities in the region: automotive parts manufacturers in Taiwan; electronics producers in Korea and Taiwan; and a host of ventures in China. These facilities will rearrange the composition of trade as well as its pattern in the region within a few years.

Developments in Other Countries

Tokyo is not the only government pursuing liberalization and deregulation. Under pressure from the United States, Taipei and Seoul have moved over the past year to open their markets and raise the value of their currencies. The leadership in Beijing is currently preparing for the tenth People's Congress in October that will set the broad outlines of economic policy for the next few years. Soviet president Mikhail Gorbachev's glasnost program has invigorated Soviet foreign policy but whether it will have any effect on economic policy remains in question.

Korea - Seoul has announced two import liberalization packages since the start of 1987. The April announcement, effective July 1, opened the door a little wider to imports of computers with processors under 32 bits, computer peripherals, automotive parts and candy. To protect the domestic industry, Seoul had barred imports of 8-bit computers and allowed imports of 16- and 32-bit units on a selective basis. Not only did the government lift the ban on the smaller capacity units, but it also agreed to drop local content requirements for computers purchased by government agencies or organizations. (The rule for small computers went into effect July 1, and is to be effective as of January 1, 1988 for large systems.) The categories of auto parts requiring a

"good" rating from the government was reduced from 12 to two; and the maximum time inspectors will take to process imported candies was cut in half to 12 days.

The second package, also directed at American opinion, was announced in early June. Tariffs on 50 miscellaneous items were reduced by 5 to 30 percent; levies on tobacco products were cut from 100 to 70 percent; and rates on photographic products were lowered by 5 to 20 percent. Imports of subcompact cars (with less than 1,000 c.c. engines) and large cars (with engines above 2,000 c.c.) were allowed for the first time since the early 1960s. The Ministry of Trade and Industry also has put textiles, electronics, engine parts, steel products and some canned food products on its liberalization list.

Seoul is also beginning to dismantle financial barriers. Greater access for foreign insurers was granted last year (although many problems remain), and there is some movement in other service areas. While the won has been allowed to appreciate against the dollar over recent months, Seoul has made it clear that this is as far as it can go for now.

Finally, political changes will play a major role. Recent moves toward greater democratization could lead to a more stable government, not only enhancing the likelihood of further trade liberalization, but also improving the investment atmosphere.

Taiwan - Taipei capped the gradual appreciation of the new Taiwan dollar by ending many controls on foreign exchange July 15. With an estimated $62 billion in foreign exchange reserves -- the result of impressive trade surpluses with the United States and others -- the reforms were necessary to stabilize the new exchange rate and placate domestic and foreign critics. Under the new rules foreign currency need not be converted immediately into local currency, and up to $5 million may be invested abroad without government approval.

Not only will the changes help insulate the domestic economy from the inflationary pressures of such huge reserves, but they will surely trigger a huge outflow of capital, some of which will almost surely flow to Japan (despite the fact that Japanese interest rates are below Taiwan's and that price/earnings ratios on the Tokyo exchange are lower than on the Taipei floor). Private bankers and businessmen have termed this the end of "economic martial law," and will soon begin to test the limits of their new freedom.

The end of 38 years of martial law earlier this year opened the door to significant political activity. The current leadership (mainly immigrants from the mainland) has been wrestling with the problem of succession for some years. The move to end martial law and allow opposition parties to organize more freely will help to defuse political pressures. The consequences of greater stability apply equally to Taiwan as to Korea.

China - The single most important question facing China is who will control economic policy, the reformers or the conservatives? Since Deng Xiaoping rose to power in the late 1970s, the movement toward a more flexible economy and the acceptance of free-market mechanisms has advanced and retreated as the clash between ideology and economics seesaws back and forth. Mr. Deng and his allies hope to cement some basic liberal principles at this year's tenth party

congress, but they have already been forced to scale back their goals. The reform group suffered a stinging defeat when Hu Yaobang, one of their members, was forced to step down as party chairman earlier this year. Conservatives seized control of the public debate for several months, and only recently have the reformers been able to reassert their will on economic policy.

The clash has wide-ranging implications for trade and investment. While foreigners are eager to deal with China, they face a multitude of uncertainties that reflect the political winds: foreign exchange restrictions, domestic price controls and policies, establishment of a favorable legal framework and independent judiciary, and import/export controls. Until China demonstrates greater political stability, caution will continue to characterize foreign strategies.

U.S.S.R. - What does glasnost mean? This is the question being asked in Tokyo and elsewhere. Mr. Gorbachev may have signaled his intentions by continuing preparations for his visit to Japan despite the uproar in the United States and Japan over the Toshiba Machine Co., Ltd. affair. While significant political barriers are likely to remain (the Northern territories issue), increasing trade may be one method of building stronger bridges between the Soviet Union and other countries of the region.

Outlook

It is clear that economic forces are reshaping trade patterns between Japan and its neighbors; economic development, shifting exchange rates and deregulation are closing old paths and opening new ones. The final component is each government's vision of where the nation should be at the beginning of the next century. Given the high degree of social order in Japan, South Korea, Taiwan and China, these long-range plans have a definite, if subtle, influence.

Japan sees itself transformed into an information-based society in the 21st century. The gathering, transmission, manipulation, storage and dissemination of information will be the cornerstone of high-technology society. Services, therefore, will play the leading role in economic growth, although manufacturing based on advanced technology will surely make a major contribution. The implications are already showing up in the trade statistics: Japan will import more and more finished products while exporting capital and services. This fits with conceptions of an "international division of labor," in which Japan, as an advanced nation, must give way to other nations as they develop comparative advantage in low-end products.

This suits South Korea just fine, since its intention seems to be to build an economy capable of competing across the entire spectrum of goods in order to pay off its large foreign debt and support its heavy defense expenditures. Having mastered the basic steel, textile and shipbuilding industries, Korean conglomerates have moved rapidly into construction, cars, and consumer and industrial electronics. By joining up with foreign firms to obtain technology, the Koreans have put both the United States and Japan on notice that they intend to be major competitors. Obviously the drive to build such an economic machine has and will require a great deal of foreign trade in both goods and services.

Taiwan's ambitions are less grand, but no less significant in terms of trade. Parts and subassemblies will be the keystone of industry, supported by high-technology light industry such as computers and peripherals. Major campaigns are being waged to attract automotive, computer and other machinery companies. The combination of low rents, a highly skilled and disciplined labor force, and abundant capital have already attracted many American firms, while Japan is rapidly building its presence. Taiwan's trade will surely grow in value added, but perhaps in only a few product groups.

China's desire is simply to become a developed country. The size and breadth of the tasks it faces are daunting. If political factors remain favorable, the potential for growth and trade are impressive. Not only does increased trade depend on China's leaders but also on the willingness of foreigners to accept the risk and uncertainty. A great many issues must be resolved before the outlook on China's trade clears.

The Soviet Union also faces political hurdles, for while it has attained superpower status in military terms, it remains economically feckless. Soviet analysts give Mr. Gorbachev an even chance at best of seeing his economic reforms put into full practice. Soviet Asia remains a stepchild in terms of priorities. Even if Moscow decides to mount a major development effort, trade may not increase significantly. Without true economic reform and political stability, trade will remain limited. Of course, should Mr. Gorbachev succeed, the picture could change completely.

Whatever China and the Soviet Union decide, Japan, Taiwan and South Korea are well on the way toward building a web of trade and investment that will link them more closely than ever. The three will have problems managing the new relationship (witness the difficulties between the United States and Japan), but manage them they will -- there is no other choice. In any case, it is clear that the region will be a center of economic activity for some decades to come. Shifting trade patterns reveal the depth of economic adjustment in progress.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.